



8011-01
SECURITIES AND EXCHANGE COMMISSION
[Release No. 34-79455; File No. SR-FINRA-2016-033]

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change to Amend Rule 12400 of the Code of Arbitration Procedure for Customer Disputes and Rule 13400 of the Code of Arbitration Procedure for Industry Disputes Relating to Broadening Chairperson Eligibility in Arbitration

December 2, 2016

I. Introduction

On August 18, 2016, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to amend Rules 12400 of the Code of Arbitration Procedure for Customer Disputes (“Customer Code”) and Rule 13400 of the Code of Arbitration Procedure for Industry Disputes (“Industry Code” and, together with the Customer Code, “Codes”).³ The proposed rule change would allow an attorney arbitrator to qualify for the chairperson roster if he or she completes chairperson training and serves as an arbitrator through award on at least one arbitration. The Codes currently require that an attorney must serve as arbitrator through award on at least two arbitrations in order to qualify for the chairperson roster.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See File No. SR-FINRA-2016-033.

The proposed rule change was published for comment in the Federal Register on September 6, 2016.⁴ The public comment period closed on September 27, 2016. The Commission received five (5) comment letters on the proposed amendments.⁵ On October 14, 2016, FINRA extended the time period in which the Commission must approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change to December 5, 2016.⁶ On November 22, 2016, FINRA responded to the comment letters received in response to the Notice.⁷ This order approves the proposed rule change.

II. Description of the Proposed Rule Change⁸

⁴ See Exchange Act Release No. 78729 (Aug. 30, 2016); 81 FR 61288 (Sept. 6, 2016) (“Notice”).

⁵ See Letters from Steven B. Caruso, Esq., Maddox Hargett Caruso, P.C. (Aug. 31, 2016) (“Caruso Letter”); Ryan K. Bakhtiari, Aidikoff, Uhl and Bakhtiari (Sept. 9, 2016) (“Bakhtiari Letter”); Hugh Berkson, President, Public Investors Arbitration Bar Association (“PIABA”) (Sept. 23, 2016) (“PIABA Letter”); Nicole Iannarone, Asst. Clinical Professor, and Geoffrey R. Hafer, Student Intern, Investor Advocacy Clinic, Georgia State University College of Law (“GSU”) (Sept. 26, 2016) (“GSU Letter”); and David T. Bellaire, Esq., Executive Vice President and General Counsel, Financial Services Institute (“FSI”) (Sept. 27, 2016) (“FSI Letter”). The comment letters are available on FINRA’s website at <http://www.finra.org>, at the principal office of FINRA, at the Commission’s website at <https://www.sec.gov/comments/sr-finra-2016-033/finra2016033.shtml>, and at the Commission’s Public Reference Room.

⁶ See Letter from Margo A. Hassan, Associate Chief Counsel, FINRA, to Lourdes Gonzalez, Assistant Chief Counsel – Sales Practices, Division of Trading and Markets, Securities and Exchange Commission, dated October 14, 2016.

⁷ See Letter from Margo A. Hassan, Associate Chief Counsel, FINRA, to Brent J. Fields, Secretary, Securities and Exchange the Commission, dated November 22, 2016 (“FINRA Letter”). The FINRA Letter is available on FINRA’s website at <http://www.finra.org>, at the principal office of FINRA, at the Commission’s website at <https://www.sec.gov/comments/sr-finra-2016-033/finra2016033.shtml>, and at the Commission’s Public Reference Room.

⁸ The subsequent description of the proposed rule change is substantially excerpted from FINRA’s description in the Notice. See Notice, 81 FR at 61288-61289.

Background

FINRA arbitrators possess the broad authority to “interpret and determine the applicability of all provisions under the Code[s]. Such interpretations are final and binding upon the parties.”⁹ To facilitate the fair administration of proceedings in the FINRA forum, arbitrators must possess sufficient qualifications and participate in appropriate training¹⁰ – particularly where an arbitrator presides over the proceeding as chairperson, with the authority to, among other things, direct witness appearances, order the production of documents and information, and set deadlines in a given case.¹¹

FINRA maintains a roster of non-public arbitrators,¹² public arbitrators,¹³ and arbitrators who are eligible to serve as chairperson in each of its 71 hearing locations.¹⁴ FINRA employs its computerized Neutral List Selection System to randomly generate lists of potential arbitrators for each proceeding from these rosters.¹⁵ The parties then select their arbitrators through a process of striking and ranking the names on the list generated by the Neutral List Selection System.¹⁶

The Codes provide that arbitrators are eligible for the chairperson roster if they have completed chairperson training provided by FINRA and:

⁹ See FINRA Rules 12409 (Jurisdiction of Panel and Authority to Interpret the Code) and 13413 (Jurisdiction of Panel and Authority to Interpret the Code).

¹⁰ See Notice, 81 FR 61289.

¹¹ See FINRA Office of Dispute Resolution Arbitrator’s Guide (Oct. 2016), at page 31, available at <http://www.finra.org/sites/default/files/arbitrators-ref-guide.pdf>.

¹² For the definition of “non-public arbitrator,” see FINRA Rules 12100(p) and 13100(p).

¹³ For the definition of “public arbitrator,” see FINRA Rules 12100(u) and 13100(u).

¹⁴ See FINRA Rules 12400(b) and 13400(b).

¹⁵ See FINRA Rules 12400(a) and 13400(a).

¹⁶ Id.

- Have a law degree and are a member of a bar of at least one jurisdiction, and have served as an arbitrator through award on at least two arbitrations administered by a self-regulatory organization in which hearings were held; or
- Have served as an arbitrator through award on at least three arbitrations administered by a self-regulatory organization in which hearings were held.¹⁷

Additionally, in customer disputes, chairpersons must be public arbitrators.¹⁸

In February 2015, the Commission approved a proposal by FINRA to amend its definition of “public arbitrator,”¹⁹ The amended definition took effect in June 2015,²⁰ resulting in the reclassification of approximately 13.8 percent of public arbitrators as non-public arbitrators, and the rendering of 2.6 percent of its public arbitrator roster as temporarily disqualified or ineligible for service.²¹ Many of the arbitrators who were reclassified or disqualified had been chair-qualified prior to the amendment.²² Currently, FINRA’s rosters contain approximately 6,750 arbitrators, of which 3,060 are currently classified as public. Of those classified as public arbitrators, approximately 1,000 are deemed chair-qualified.²³

FINRA contends that forum users have complained about the diminished availability of public chairpersons after the amendment to the public arbitrator definition. FINRA also states

¹⁷ See FINRA Rules 12400(c) and 13400(c).

¹⁸ See FINRA Rule 12400(c).

¹⁹ See Exchange Act Release No. 74383 (Feb. 26, 2015), 80 FR 11695 (Mar. 4, 2015) (Order Approving Filing No. SR-FINRA-2014-028) (in part narrowing the public arbitrator definition by adding disqualifications relating to, among other things, affiliations with the securities industry concerning an arbitrator’s family member or place of employment).

²⁰ See Notice, 81 FR 61288.

²¹ See id.

²² See id.

²³ See id.

that forum users have complained of scheduling difficulties and additional costs associated with traveling chairpersons (i.e., public chairpersons that FINRA asks to travel to other hearing locations to expand the roster of available public chairpersons for a given location), as well as out-of-town arbitrators' lack of familiarity with local venue customs and procedures.²⁴

Moreover, FINRA states that it has had limited success in enrolling new public chairpersons, and that the need for public chairpersons could potentially surpass the availability of public chairpersons who meet the qualifications under the existing Codes.²⁵

Proposed Rule Change

FINRA is proposing to amend the eligibility requirements under the Codes for arbitrators who seek to qualify as chairpersons. The amendment would allow an attorney arbitrator to qualify for the chairperson roster if he or she completes chairperson training and serves as an arbitrator through award on at least one arbitration administered by a self-regulatory organization where hearings are held, instead of two arbitrations (as is currently required). FINRA is also proposing to replace the bullets in Rules 12400 and 13400 with numbers for ease of citation.

FINRA states that reducing the case experience requirement for would-be arbitrators from two arbitrations to one arbitration could add more than 270 attorney arbitrators across 59 of its 71 hearing locations, potentially resulting in a nearly 30 percent increase in the number of arbitrators who might be eligible to serve as public chairpersons once they take chairperson training.²⁶ FINRA also believes that the proposed rule change would increase the availability of

²⁴ See id.

²⁵ See id.

²⁶ See id. at 61289.

local chairpersons for forum users, lowering instances in which chairpersons must travel, and ameliorating parties' concerns regarding out-of-town arbitrators.²⁷

III. Summary of Comments and FINRA's Response

The Commission received five (5) comment letters on the proposed rule change,²⁸ and a response letter from FINRA.²⁹ Three commenters supported the amendment,³⁰ and two generally supported the amendment while advocating for further action.³¹ FINRA's response to commenters' concerns and suggestions are incorporated below.

Comment Letters in Support of the Proposal

As noted above, three commenters supported FINRA's proposed amendments to the Codes. One commenter stated that the proposal would "be a fair, equitable and reasonable approach that would facilitate the increased appointment of local chairpersons to arbitration panels and, at the same time, would reduce the necessity for the appointment of out-of-state chairpersons."³² A second commenter supported the proposed amendment on the ground that it "would significantly increase the available number of arbitrators included on the Chair roster and represents an important step towards increasing the probability of drawing local chairpersons in suburban or remote hearing locations."³³ A third commenter supported the proposal based on its

²⁷ See id.

²⁸ See supra note 5.

²⁹ See supra note 7.

³⁰ See Caruso Letter, Bakhtiari Letter, and FSI Letter.

³¹ See PIABA Letter and GSU Letter.

³² See Caruso Letter.

³³ See Bakhtiari Letter.

belief that the requirement of a law degree and participation in one arbitration through award are reasonable criteria for a public chair.³⁴

Supportive Comment Letters Recommending Modifications to the Proposal

Two comment letters recommended modifications to the proposal, while generally expressing support for the proposal. One commenter stated that investors would “benefit from a larger pool of qualified public chairpersons” and generally supported the proposed rule as “a positive step in regards to increasing the number of arbitrators in proposed chair pools[.]”³⁵ Another commenter stated that it “applaud[s] FINRA’s decision to expand the public arbitrator chair pool[.]”³⁶ However, both commenters raised additional concerns and suggestions for the proposed amendment.

- Enhancing Transparency of the Arbitrator Selection Process

One commenter advocated for greater transparency regarding arbitrators’ backgrounds and qualifications, as well as greater transparency in the arbitrator selection process generally in order to improve investor confidence in FINRA arbitrators.³⁷ According to this commenter, FINRA’s current disclosure system, which provides information regarding arbitrators’ education, employment history and potential conflicts, is insufficient to eliminate the appearance of impropriety and bias.³⁸

In response, FINRA stated that it produces a disclosure report reflecting the prior employment, educational history, and previous arbitration awards for every potential arbitrator

³⁴ See FSI Letter.

³⁵ See PIABA Letter.

³⁶ See GSU Letter.

³⁷ See PIABA Letter.

³⁸ Id.

during the appointment process.³⁹ FINRA also requires arbitrators to either certify the accuracy of the information in the disclosure report or update the report when they are appointed to a case.⁴⁰ In addition, FINRA reminds arbitrators on a quarterly basis to review their disclosure reports and revise them as needed. Moreover, FINRA stated that it is revising its disclosure reporting system to alert parties of the last time the arbitrator certified the accuracy of the information contained therein.⁴¹

- Use of Out-of-Town Arbitrators and Recruitment Initiatives

One commenter stated that the overall reduction in the number of eligible chairpersons has reduced the pool of local chairpersons, and caused FINRA to ask non-local chairpersons to travel to multiple hearing locations.⁴² This commenter believes that the use of non-local arbitrators has resulted in inconvenience, delay, and additional costs to parties, and has led to a decrease in customer awards because of non-local arbitrators' purported bias in favor of the industry.⁴³ For these reasons, the commenter suggested that, to the extent possible, FINRA should eliminate the use of non-local arbitrators and increase the size of regional pools – especially where out-of-state arbitrators regularly appear on public and chair-qualified ranking lists.⁴⁴

³⁹ See FINRA Letter.

⁴⁰ Id.

⁴¹ Id.

⁴² See PIABA Letter.

⁴³ See id.

⁴⁴ See id.

In its response, FINRA stated that it uses arbitrators in neighboring hearing locations “to ensure an effective ratio of available arbitrators to open cases in each location[.]”⁴⁵ For example, “as an interim measure, FINRA took steps to bolster the pool of arbitrators in smaller hearing locations that were impacted by the amended public arbitrator definition by asking chairs from larger hearing locations . . . if they would be willing to serve[.]”⁴⁶ FINRA also stated, however, that it agrees that it should increase the size of its public arbitrator pool, and stated that it has been “actively recruiting new arbitrators, paying particular attention to locations with the greatest need.”⁴⁷

- Additional Chairperson Training and Mentorship

One commenter expressed the concern that the proposed rule change might sacrifice chairperson quality at the expense of chairperson quantity, as “quality pools are paramount to a fair and equitable arbitration proceeding, as well as the public investors’ confidence in the overall arbitration process.”⁴⁸ The commenter therefore recommended, in part, that FINRA adopt a “Chairperson Mentor program” to increase the quality of chair-qualified arbitrators.⁴⁹

Another commenter similarly asserted that, by expanding chairperson eligibility, the proposed rule change would reduce arbitrators’ exposure to live proceedings prior to serving as a chair.⁵⁰ To address this reduction in experience, the commenter proposed that FINRA “include in the Office of Dispute Resolution Chairperson Training a module or section that specifically

⁴⁵ See FINRA Letter.

⁴⁶ Id.

⁴⁷ Id.

⁴⁸ See PIABA Letter.

⁴⁹ Id.

⁵⁰ See GSU Letter.

addresses the procedural and substantive issues that regularly arise in live arbitration proceedings.”⁵¹ Alternatively, the commenter proposed that FINRA require arbitrators to observe a live or mock proceeding before becoming eligible to serve as a public chair.⁵²

In response, FINRA stated that, earlier this year, it implemented a chairperson mentorship program to facilitate interaction between new chairpersons and experienced chairpersons.⁵³ In addition, in November 2016, FINRA provided arbitrators access to online workshops that address issues chairpersons regularly encounter.⁵⁴ Moreover, FINRA stated that it regularly invites qualified arbitrators to complete chairperson training.⁵⁵

- Simplifying the Arbitrator Application Process

One commenter expressed concern that the arbitrator application process is “burdensome and intimidating and surely drives away many potential arbitrators which further weakens the number and quality of arbitrators available in the FINRA system.”⁵⁶ Accordingly, PIABA suggested that FINRA simplify the arbitrator application process.⁵⁷

FINRA responded that, in 2017, it plans to replace the “time-consuming” “Securities Disputes Experience” section of the arbitrator application with a section that allows applicants to

⁵¹ Id.

⁵² Id.

⁵³ See FINRA Letter.

⁵⁴ Id.

⁵⁵ Id.

⁵⁶ See PIABA Letter.

⁵⁷ Id.

explain their securities disputes expertise and skills in narrative form.⁵⁸ FINRA believes that this change will simplify the arbitrator application process.⁵⁹

- Revisiting the “Public Arbitrator” Definition

One commenter cited the 2015 amendments to the definition of “Public Arbitrator” as a significant contributor to the reduction in the chairperson roster overall and disproportionately for claimants with smaller claims.⁶⁰ For instance, GSU stated that there are only 40 chair-qualified arbitrators in its primary hearing location, Atlanta.⁶¹ The commenter thus recommended that FINRA revisit the 2015 amendments to the public arbitrator definition as a means for increasing the chairperson roster.

In response, FINRA stated that it had revisited the 2015 amendments to the arbitrator definitions and determined not to change the public arbitrator definition, as FINRA deemed it important for public arbitrators to have no significant affiliation with the financial industry.⁶² However, FINRA noted that a gap exists between the public and non-public arbitrator definitions, which excludes otherwise qualified individuals from service as arbitrators – often because of family or co-workers’ affiliations.⁶³ According to FINRA, in September 2016, its Board of Governors authorized FINRA to file with the Commission proposed amendments to Rules 12100 and 13100 of the Codes to revise the non-public arbitrator definition.⁶⁴ These

⁵⁸ See FINRA Letter.

⁵⁹ Id.

⁶⁰ See GSU Letter.

⁶¹ Id.

⁶² See FINRA Letter.

⁶³ Id.

⁶⁴ Id.

amendments would define a non-public arbitrator as a person who is otherwise qualified to serve as an arbitrator, and is disqualified from classification as a public arbitrator.⁶⁵ By closing this gap, FINRA asserted that it could expand its roster of available arbitrators.⁶⁶

IV. Discussion and Commission Findings

The Commission has carefully considered the proposal, the comments received, and FINRA's response to the comments. Based on its review of the record, the Commission finds that the proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to a national securities association.⁶⁷ In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Exchange Act,⁶⁸ which requires, among other things, that FINRA's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

As discussed above, the proposal would amend Rules 12400 and 13400 of the Codes to allow an attorney arbitrator to qualify for the chairperson roster if he or she completes chairperson training and serves as an arbitrator through award on at least one arbitration administered by a self-regulatory organization where hearings are held, instead of two arbitrations (as is currently required). It would also replace the bullets in Rules 12400 and 13400 with numbers for ease of citation.

⁶⁵ Id.

⁶⁶ Id.

⁶⁷ In approving the proposed rule change, the Commission has also considered its impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

⁶⁸ 15 U.S.C. 78o-3(b)(6).

The Commission has considered the five (5) comment letters received on the proposed rule change,⁶⁹ along with FINRA’s response to the comments.⁷⁰ The Commission acknowledges the supportive commenters’ positions that the proposal would “be a fair, equitable and reasonable approach that would facilitate the increased appointment of local chairpersons to arbitration panels,”⁷¹ that it “would significantly increase the available number of arbitrators included on the Chair roster and represents an important step towards increasing the probability of drawing local chairpersons in suburban or remote hearing locations,”⁷² and that the requirement of a law degree and participation in one arbitration through award are reasonable criteria for a public chair.⁷³ However, the Commission also acknowledges commenters’ concerns and recommended modifications to the proposal.⁷⁴ These concerns and modifications are discussed below.

- Enhancing Transparency of the Arbitrator Selection Process

The Commission acknowledges the commenter’s concern that FINRA’s current disclosure system does not always eliminate the appearance of impropriety and bias in the FINRA arbitration forum, and agrees that transparency in the arbitrator selection process improves investor confidence in FINRA arbitrators.⁷⁵ However, the Commission believes that FINRA’s disclosure reporting system provides parties with a basis on which to identify potential

⁶⁹ See supra note 5.

⁷⁰ See supra note 7.

⁷¹ See Caruso Letter.

⁷² See Bakhtiari Letter.

⁷³ See FSI Letter.

⁷⁴ See PIABA Letter and GSU Letter.

⁷⁵ See PIABA Letter.

arbitrator conflicts and biases. Moreover, the Commission believes that by reminding arbitrators to update their disclosure reports, and notifying parties of the last date an arbitrator certified the accuracy of the disclosure report, FINRA will further help ensure that parties have up-to-date information on which to base their arbitrator selections.

- Use of Out-of-Town Arbitrators and Recruitment Initiatives

The Commission acknowledges the commenter's concerns regarding the inconvenience, delay, and additional costs caused by the use of non-local arbitrators.⁷⁶ However, given the reported insufficient levels of local chairpersons in certain hearing locations,⁷⁷ the Commission does not believe it is feasible or practical to eliminate the use of non-local arbitrators, as the commenter suggested.⁷⁸ Instead, the Commission acknowledges the necessity of FINRA's policy of asking public chairs from larger, geographically proximate hearing locations to serve as chairpersons in regions with insufficient levels of local qualified chairpersons. The Commission additionally supports FINRA's increased arbitrator recruitment efforts, and anticipates that such efforts will eventually result in a broader, more diverse pool of arbitrator candidates.

- Additional Chairperson Training and Mentorship

With regard to commenters' concerns that the proposed amendment might decrease the quality and experience of arbitrator chairpersons at the expense of increasing the quantity of chairpersons, the Commission acknowledges their recommendation that a mentor program or additional trainings should be provided to chairpersons.⁷⁹ The Commission generally believes

⁷⁶ Id.

⁷⁷ See FINRA Letter.

⁷⁸ See PIABA Letter.

⁷⁹ See PIABA Letter and GSU Letter.

that FINRA's implementation of a chairperson mentorship program, as well as its increased provision of and focus on arbitrator trainings should effectively address the commenters' concerns.

- Simplifying the Arbitrator Application Process

The Commission acknowledges the concern expressed regarding FINRA's purportedly burdensome and intimidating arbitrator application process, and the potential deterrent effect the process might have on would-be arbitrator applicants.⁸⁰ However, the Commission believes that a rigorous application process is necessary to verify the qualifications of arbitrator candidates. Furthermore, the Commission expects that FINRA's use of a narrative application section where applicants can explain their securities disputes expertise and skills will simplify the arbitrator application process without degrading the value of the elicited information, thereby addressing the commenter's concern.

- Revisiting the "Public Arbitrator" Definition

The Commission acknowledges the commenter's suggestion that FINRA reconsider the 2015 amendments to the public arbitrator definition in an effort to combat the resulting reduction in the chairperson roster.⁸¹ However, at the time the Commission approved the 2015 amendments to the public arbitrator definition, the Commission determined that the approach proposed by FINRA was appropriate and designed to protect investors and the public interest, consistent with Section 15A(b)(6) of the Exchange Act and the rules and regulations thereunder.⁸² Accordingly, the Commission also gives due regard to FINRA's decision not to

⁸⁰ See PIABA Letter.

⁸¹ See GSU Letter.

⁸² See 80 FR 11695 at 11704-11705.

amend the definition of public arbitrator at this time.⁸³ Nevertheless, the Commission will give appropriate consideration to any proposed amendments to FINRA Rules 12100 and 13100 to revise the non-public arbitrator definition to eliminate any gaps in the Codes' arbitrator classifications that could expand its roster of available arbitrators.

Taking into consideration the comments and FINRA's responses, the Commission finds that the proposal is consistent with the Exchange Act. Specifically, the Commission believes that the proposal will help protect investors and the public interest by, among other things, broadening the roster of available arbitrator chairpersons, while preserving the quality of arbitrators who would serve as chairpersons. Furthermore, the Commission believes that FINRA's responses, as discussed in more detail above, appropriately addressed commenters' concerns and adequately explained FINRA's reasons for declining to modify its proposal. Accordingly, the Commission believes that the approach proposed by FINRA is appropriate and designed to protect investors and the public interest, consistent with Section 15A(b)(6) of the Exchange Act and the rules and regulations thereunder.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,⁸⁴ that the proposed rule change (SR-FINRA-2016-033) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁸⁵

Eduardo A. Aleman

⁸³ See FINRA Letter.

⁸⁴ 15 U.S.C. 78s(b)(2).

⁸⁵ 17 CFR 200.30-3(a)(12).

Assistant Secretary

[FR Doc. 2016-29385 Filed: 12/7/2016 8:45 am; Publication Date: 12/8/2016]